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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9763]

RIN 1545-BM20

Determination of Adjusted Applicable Federal Rates under Section 1288 and the Adjusted Federal Long-Term Rate under Section 382

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final Regulations.

SUMMARY: This document contains final regulations that provide the method to be used to adjust the applicable Federal rates (AFRs) to determine the corresponding rates under section 1288 of the Internal Revenue Code (Code) for tax-exempt obligations (adjusted AFRs) and the method to be used to determine the long-term tax-exempt rate and the adjusted Federal long-term rate under section 382. For tax-exempt obligations, the regulations affect the determination of original issue discount under section 1273 and of total unstated interest under section 483. In addition, the regulations affect the determination of the limitations under sections 382 and 383 on the use of certain operating loss carryforwards, tax credits, and other attributes of corporations following ownership changes.

DATES: Effective Date: These regulations are effective on **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Applicability Dates: For the dates of applicability, see §§1.382-12(d) and 1.1288-1(c).

FOR FURTHER INFORMATION CONTACT: Concerning the regulations under section 1288, Jason G. Kurth at (202) 317-6842; concerning the regulations under section 382, William W. Burhop at (202) 317-6847.

SUPPLEMENTARY INFORMATION:

Background

On March 2, 2015, the IRS and the Treasury Department published a notice of proposed rulemaking (REG-136018-13) in the **Federal Register** (80 FR 11141) proposing the method to be used to determine the adjusted AFRs for tax-exempt obligations under section 1288 and the method to be used to determine the long-term tax-exempt rate and the adjusted Federal long-term rate under section 382. No comments were received on the notice of proposed rulemaking. No public hearing was requested or held. Accordingly, this Treasury decision adopts the proposed regulations without substantive change.

Explanation of Provisions

The regulations in this Treasury decision provide the new method by which the Treasury Department and the IRS will determine the adjusted AFRs under section 1288 to take into account the tax exemption for interest on tax-exempt obligations (as defined in section 1275(a)(3) and §1.1275-1(e)). The regulations also provide that the Treasury Department and the IRS will use the new method to determine the long-term tax-exempt rate and the adjusted Federal long-term rate under section 382(f) to take into account differences between rates on long-term taxable and tax-exempt obligations.

Since November 1986, the adjusted Federal long-term rate published under section 382(f)(2) has been equal to the long-term adjusted AFR with annual compounding published under section 1288(b) in the same month. See Rev. Rul. 86-133 (1986-2 CB 59). For calendar months from November 1986 to February 2013, the Treasury Department determined the adjusted Federal long-term rate and each adjusted AFR described in section 1288(b)(1) by multiplying the corresponding AFR by a fraction (the adjustment factor). The numerator of the adjustment factor was a composite yield of the highest-grade tax-exempt obligations available, which are prime, general obligation tax-exempt obligations. The denominator was a composite yield of U.S. Treasury obligations with maturities similar to those of the tax-exempt obligations. Each of the composite yields was measured over a one-month period.

The IRS published Notice 2013-4 (2013-9 IRB 527) on February 25, 2013, requesting comments on possible modifications to the method by which adjusted AFRs and the adjusted Federal long-term rate are determined. The IRS requested comments on these possible modifications because, since the beginning of 2008, market yields of prime, general obligation tax-exempt obligations had sometimes exceeded market yields of comparable U.S. Treasury obligations, causing the adjusted Federal long-term rate and each adjusted AFR to exceed the corresponding AFRs. Adjusted rates that are higher than the corresponding AFRs indicate that the adjustment factor no longer served the purposes of sections 1288(b)(1) and 382(f)(2), which were intended to adjust only for the tax exemption. These rates were also inconsistent with the express intention of Congress that the adjusted Federal long-term rate and the long-term tax-

exempt rate be lower than the Federal long-term rate. See 2 H.R. Rep. No. 99-841 (Conf. Rep.), 99th Cong., 2d Sess. II-188 (1986) (1986-3 CB (Vol. 4) 1, 188).

Notice 2013-4 also provided that, until the Treasury Department and the IRS issue further guidance, the adjusted AFRs and the long-term tax-exempt rate would continue to be calculated using the adjustment factor, except that the adjustment factor would equal one (1) for any month in which the adjustment factor would otherwise be greater than one or in which the denominator of the adjustment factor would otherwise be less than or equal to zero.

After reviewing comments received in response to Notice 2013-4, the Treasury Department and the IRS issued a notice of proposed rulemaking (REG-136018-13) proposing the regulations that are adopted in this Treasury decision. The regulations use historical market data to create an appropriate adjustment factor based on individual tax rates. The regulations provide that the adjusted AFRs and the adjusted Federal long-term rate for each month will be determined from the appropriate AFRs for that month using the adjustment factor that results from the following calculation: $100 \text{ percent} - [(a \text{ combined tax rate}) \times (a \text{ fixed percentage})]$.

The tax rate in the adjustment factor is the sum of the maximum individual rate under section 1 and the maximum individual rate under section 1411 for the month to which the rate applies. The fixed percentage is the amount by which that combined tax rate must be multiplied to reflect the historical relationship between the maximum tax rate and the spread between yields of taxable and tax-exempt obligations. The fixed percentage in the adjustment factor is 59 percent, because the yield on tax-exempt obligations from February 1986 to July 2007 was lower than that of comparable taxable

obligations by, on average, 59 percent of the maximum individual rate in effect under section 1.

Therefore, the adjustment factor under current tax rates would be 74.39 percent, the result of subtracting 25.61 percent (the product of 43.4 percent (the sum of the current maximum individual rate under section 1 (39.6 percent) and the current maximum individual rate under section 1411 (3.8 percent)) and 59 percent) from 100 percent. If an AFR for a given month were 5 percent, under current tax rates, the corresponding adjusted AFR would be 3.72 percent: the product of 74.39 percent and 5 percent. If that 5 percent AFR were the Federal long-term rate for debt instruments with annual compounding, the adjusted Federal long-term rate under section 382 would likewise be 3.72 percent.

As noted previously, because no comments were received on the proposed regulations, the final regulations adopt the proposed regulations without substantive change.

Effective/Applicability Date

These regulations apply to determine the adjusted AFRs, adjusted Federal long-term rate, and long-term tax-exempt rate beginning with the rates determined during August 2016 that apply during September 2016.

Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not

apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the proposed regulations preceding these final regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small businesses. No comments were received.

Drafting Information

The principal authors of these regulations are Jason G. Kurth, IRS Office of the Associate Chief Counsel (Financial Institutions and Products) and William W. Burhop, IRS Office of the Associate Chief Counsel (Corporate). However, other personnel from the Treasury Department and the IRS participated in their development.

Availability of IRS Documents

The IRS revenue ruling and notice cited in this Treasury decision are made available by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.382-12 also issued under 26 U.S.C. 382(f) and 26 U.S.C. 382(m). * * *

Section 1.1288-1 also issued under 26 U.S.C. 1288(b). * * *

Par. 2. Section 1.382-1 is amended by revising the introductory text and adding an entry for §1.382-12 to read as follows:

§1.382-1 Table of contents.

This section lists the captions that appear in the regulations for §§1.382-2 through 1.382-12.

* * * * *

§1.382-12 Determination of adjusted Federal long-term rate.

- (a) In general.
- (b) Adjusted Federal long-term rate.
- (c) Adjustment factor.
- (d) Effective/applicability date.

Par. 3. Section 1.382-12 is added to read as follows:

§1.382-12 Determination of adjusted Federal long-term rate.

(a) In general. The long-term tax-exempt rate for an ownership change is the highest of the adjusted Federal long-term rates in effect for any month in the 3-calendar-month period ending with the calendar month in which the change date occurs. For purposes of the previous sentence, the adjusted Federal long-term rate is the Federal long-term rate determined under section 1274(d) (without regard to paragraphs (2) and (3) thereof), adjusted for differences between rates on long-term taxable and tax-exempt obligations. The Secretary calculates the adjusted Federal long-term rate as provided in paragraph (b) of this section. The Internal Revenue Service publishes the long-term tax-exempt rate and the adjusted Federal long-term rate for each month in the Internal Revenue Bulletin (see §601.601(d)(2)(ii) of this chapter).

(b) Adjusted Federal long-term rate. The adjusted Federal long-term rate for a calendar month is the product of the Federal long-term rate determined under section 1274(d) for that month, based on annual compounding, multiplied by the adjustment factor described in paragraph (c) of this section.

(c) Adjustment factor. The adjustment factor is a percentage equal to--

(1) The excess of 100 percent, over

(2) The product of--

(i) 59 percent, and

(ii) The sum of the maximum rate in effect under section 1 applicable to individuals and the maximum rate in effect under section 1411 applicable to individuals for the month to which the adjusted applicable Federal rate applies.

(d) Effective/applicability date. The rules of this section apply to the determination of the long-term tax-exempt rate and the adjusted Federal long-term rate beginning with the rates determined during August 2016 that apply during September 2016.

Par. 4. Section 1.1288-1 is added to read as follows:

§1.1288-1 Adjustment of applicable Federal rate for tax-exempt obligations.

(a) In general. In applying section 483 or section 1274 to a tax-exempt obligation, the applicable Federal rate is adjusted to take into account the tax exemption for interest on the obligation. For each applicable Federal rate determined under section 1274(d), the Secretary computes a corresponding adjusted applicable Federal rate by multiplying the applicable Federal rate by the adjustment factor described in paragraph (b) of this section. The Internal Revenue Service publishes the applicable

Federal rates and the adjusted applicable Federal rates for each month in the Internal Revenue Bulletin (see §601.601(d)(2)(ii) of this chapter).

(b) Adjustment factor. The adjustment factor is a percentage equal to--

(1) The excess of 100 percent, over

(2) The product of--

(i) 59 percent, and

(ii) The sum of the maximum rate in effect under section 1 applicable to individuals and the maximum rate in effect under section 1411 applicable to individuals for the month to which the adjusted applicable Federal rate applies.

(c) Effective/applicability date. The rules of this section apply to the determination of adjusted applicable Federal rates beginning with the rates determined during August 2016 that apply during September 2016.

John Dalrymple,

Deputy Commissioner for Services and Enforcement.

Approved: April 8, 2016.

Mark J. Mazur,

Assistant Secretary of the Treasury (Tax Policy).

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